

# Fiscal Sector Reform



USAID Bosnia and Herzegovina  
Economic Development Office

USAID

The purpose of this SOW is to identify and recommend activities to be carried out in the fiscal sector, with the ultimate goal of improving fiscal and public expenditure management, through a comprehensive approach that will ensure better coordination and management between all levels of economic government, increased compliance, and a simplified business environment and fiscal regulatory framework.

## Table of Contents

Objective .....	2
Scope of the activity.....	2
Country background and Development context .....	2
Problem Statement and Major Issues.....	4
Executive Summary.....	5
Relationship to the CDCS, and applicable agency policies.....	9
USAID Achievements in the Fiscal Sector to date.....	10
Other Donors in the Fiscal Sector .....	10
Recent achievements in support of the activity .....	12
Methodologies .....	13
Illustrative activities .....	14
Monitoring, Evaluation, and Learning .....	26
Sustainability Analysis.....	27
Environmental Analysis.....	28
Gender Analysis .....	28
Critical Assumptions and Risks.....	29
Funding Requirements.....	<b>Error! Bookmark not defined.</b>
Possible Implementing Mechanisms .....	<b>Error! Bookmark not defined.</b>

## Objective

The purpose of this SOW is to identify and recommend interventions to be carried out in the fiscal sector, with the ultimate goal of improving fiscal and public expenditure management through a comprehensive approach that will ensure better coordination and management between all levels of economic government, increased compliance, and a simplified business environment and fiscal regulatory framework. Through the Fiscal Sector Reform (FSR) activity, USAID will support efforts that facilitate gains in fiscal space and public investment that, in turn, spur increasing private domestic and foreign investment in Bosnia and Herzegovina (BiH).

## Scope of the activity

The project will be implemented in five years, starting in fall of 2014. The focus area of the activity is a fiscal discipline, which entails comprehensive set of initiatives tackling coordination between the different levels of the BiH governments, and additional work with governmental institutions such as the tax administrations. The main activity tasks are:

- A.1 Assistance for the Fiscal Council
- A.2 Strengthening of the FBiH Treasury System and
- A.3 Strengthening of the PIFC
- A.4 Strengthening of the Public Debt
- A.5 Increased compliance and improved business environment
  - A.5.1 Reducing tax evasion
  - A.5.2 Business environment
  - A.5.3 Elimination of nuisance taxes

## Country background and Development context

Some seventeen years after the 1992-1995 war BiH still struggles to perform basic governmental functions and has not transitioned to full sovereignty given the remaining outstanding conditions needed for closure of the Office of the High Representative (OHR). OHR is an ad hoc international institution created by the Dayton Peace Accords (DPA) and responsible for overseeing the implementation of civilian aspects of the DPA which ended the war in BiH. While OHR prepares to close, the European Union (EU) has pledged to increase its commitment to Bosnia and Herzegovina. The EU has recently confirmed this commitment with appointment of a European Union Special Representative (EUSR). The EU Delegation will take on the fundamental duties for steering the country toward EU membership once OHR closes.

BiH remains deeply divided along ethnic lines. Divisive ethno-nationalist rhetoric exists at almost every political level, in the popular media, in the education system, and in more subtle aspects of social life. The most recent examples are the confrontational discussions between Bosniak and Serb government officials regarding the indictments of two Bosniak military commanders from Srebrenica region, initiated by the court in Serbia. Republika Srpska officials threatened to abandon the joint state institutions

because BiH state institutions refused to extradite the accused. These divisions inflame distrust and impede progress in virtually every socio-political and economic area.

The country consists of two entities and one district: Federation of Bosnia and Herzegovina (FBiH), the Republic of Srpska (RS), and Brčko District (BD). All three entities have governments with almost identical, and often overlapping competencies (executive, legal and judicial).

The differences that hamper the harmonization between the entities and establishment of the single economic space are closely tied to the administrative structure of the entities: FBiH is a highly decentralized entity consisting of three levels of government, with shared competencies and a complex internal administrative structure; Republika Srpska is a highly centralized entity with two levels of government; the District of Brčko has a special status, it is jointly owned by the two Entities but not managed by either. The BD has fields of competence that are nearly the same as those of the Entities, as well as social systems that are shared with the entities (e.g. pension system). State legislation directly applies to the District. Federation of BiH consists of ten cantons. There are 80 municipalities in the FBiH and 62 municipalities in the RS. State-level institutions are very limited in their capacities, and there are only a few such institutions that have national-level competencies and authorities that merit support (including the Ministry of Justice and State Parliament). What is highly problematic and presently unsustainable is the way in which the continued functioning of the state institutions and the exercise of exclusive state competencies can be undermined by Entity/constituent people-based quorum and voting rules. Furthermore, competencies shared between the state and Entities are configured in such a way that there are inadequate mechanisms to ensure Entity compliance with state or joint policy. This is a major problem given that policy-making and coordination capacities are also important for the European Integration process. The EU's Chapter 34<sup>1</sup> of the *acquis* requires EU aspirant countries to establish necessary bodies and mechanisms to be able to operate effectively within the EU. The EU's Stabilization and Association Agreement (SAA) requires BiH to ensure proper policy-making coordination between all levels of government.

SAA's economic criteria for integration with the EU require the existence of a functioning and competitive market economy in BiH that meets strict EU standards and practices regulating the business environment. Between 2006 and 2010, BiH made significant efforts to improve its business environment and attract more foreign investment. The reforms implemented during this period targeted the regulatory/policy arena, and they were almost exclusively initiated and implemented by the international community. A significant slowdown in implementation, as well as in initiation of new reforms, has been noticeable in the last two years. Recent EU Progress reports (2012 and 2013) on countries from the region show that BiH made very limited progress towards meeting SAA criteria, while Montenegro, Albania and Macedonia were praised for progress in almost all SAA areas. Croatia became a full EU member in July 2013, while Serbia was awarded candidate status enabling the country to access significant accession funds. Meanwhile, BiH continues to lag behind countries in the region in terms of the EU accession process. The EU Country Progress Reports for 2012 and 2013 concluded that

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<sup>1</sup> For the latest codification of the *acquis* chapters, see [http://ec.europa.eu/comm/enlargement/negotiations\\_hr\\_tk/chapters.htm#Chapters](http://ec.europa.eu/comm/enlargement/negotiations_hr_tk/chapters.htm#Chapters)

*“Bosnia and Herzegovina has made little further progress towards a functioning market economy.”* The same reports stressed that BiH needs to improve competitiveness and productivity, attract investment, and make economic policy reforms. According to the aforementioned reports BiH’s efforts remain insufficient in meeting many European standards criteria areas, including customs and taxation, public procurement, labor and employment, industry, SME business environment, food safety, veterinary and phyto-sanitary sectors, environment, transportation, energy, information and communication sector, fiscal and financial management, and statistics.

If the aforementioned problems are not addressed immediately, BiH will remain unattractive to investors, simply because other countries are advancing at a faster pace than BiH. The World Bank’s Doing Business (DB) Report starkly illustrates BiH’s development stagnation. In 2011, DB ranked BiH at 110th place out of 183 countries. Although positive reforms were implemented in BiH during the last three years, other economies improved at a faster pace than BiH. The slow pace of reforms in the last few years resulted in BiH being pushed to 131st place in the 2014 World Bank’s DB report – the worst performance in Europe. All other countries in the region are ranked below 100th place, and the closest ranked European country to BiH is Ukraine at 119th place.

#### *Bosnia and Herzegovina snapshots*

<i>GDP growth</i>	<i>- 1.1%</i>
<i>Government expenditures share of GDP</i>	<i>45%</i>
<i>CAD % of GDP</i>	<i>-9.67%</i>
<i>Public Debt of GDP</i>	<i>43.3%</i>

## Problem Statement and Major Issues

In 2012, the economy contracted by an estimated 1.1%, after a slight improvement recorded during the previous two years. Declining wages and raising unemployment rates, coupled with decelerating lending, resulted in reduced consumption heavily affecting trading and service industries. At the same time, the economic crisis in the EU, BiH’s traditional export markets, led to a negative contribution of net exports to growth. Industrial production fell by 5.3% in 2012, compared with a 5.9% expansion the previous year. Per capita income, measured in purchasing power standards (PPS), decreased from 30% in 2011 to **28% of the EU average** in 2012. The downturn in economic activity has shrunk the tax base with the budget revenue-to-GDP ratio falling to 39.9%, while public expenditures expanded further. Thus, in 2012 the budget deficit increased to 1.5% of GDP, from 0.7% of GDP a year earlier.

Bosnia and Herzegovina recorded a current account deficit of 386.30 BAM Million in the third quarter of 2013, or -9.67% of GDP. The trade deficit increased by 1.2% and reached 32.7% of GDP, as exports fell by 1.9%, while imports stagnated. The surplus in services also decreased further adding to a higher current account deficit. The current account deficit was financed mainly by external borrowing and to a certain extent by foreign direct investment (FDI). As a share of GDP, FDI decreased year-on-year from 0.5 % to 2.2% in 2012, continuing its downward trend in 2013. (FDI has dropped approximately 80% since 2007).

The financing of the deficit increasingly relied on foreign borrowing, leading to an increase in public external debt. Bosnia and Herzegovina's public debt increased to 43.3% of GDP in 2013 as compared with 40.9% of GDP a year ago (over 5.5 billion Euros). Of that, 68% is external debt to foreign creditors. The external public debt expanded by an additional 7.4% to a total of 27.9% of GDP. Public debt servicing doubled since 2007 and reached over 3% of GDP in 2012. The World Bank group remains the largest creditor, while public international creditors (EIB, ERRD, IMF) account for over 90% of the country's external public debt.

Unemployment remains very high and reached 28.6% in 2012 from 28% a year earlier (ILO measuring accounts for grey market). Total employment levels stagnated through 2012 and marginally decreased (-0.6%) year on year in the first half of 2013.

Meanwhile, "unproductive employment" continues to be a problem. The number of employees in public administration continued to rise throughout 2012 and the first half of 2013, thus further increasing the overbearing size of BiH's public sector. Unemployment was particularly high among youth (63.1% for people aged between 15 and 24-- by WB's Labor Force Study). The very high unemployment rate and the huge difference between the registered and survey-based labor figures (44% vs. 28%) suggest the existence of a large informal labor market and significant structural rigidities culminating in extremely high rates of social security contributions.

The consolidated budget deficit increased to 2.1% of GDP, compared with 1.3% in 2011, due to higher public expenditure growth (2.4%). The share of general government expenditures remained relatively high at approximately 45% of GDP and revenue at about 44% of GDP. Social security contributions – accounting for over 1/3 of the overall revenues – remained the same, and, as noted above, at a relatively very high level.

The breakdown of public spending remained highly unfavorable with current expenditures representing 95% of total expenditures, while capital spending remained demoted. All main expenditure categories increased during the year indicating some loosening of fiscal discipline. Government purchases of goods and services grew by 3.2%, while expenditures on social benefits increased by 1.5%. Fiscal imbalances worsened in 2013 due to reduced revenues from indirect taxes resulting mostly from high VAT refunds. Lower revenues were partly compensated by delays in the implementation of some capital/public investment projects. The general government balance in the first six months of 2013 turned positive and amounted to 0.4% of annual GDP. (Statistics provided from the 2013 EC Economy Report for Bosnia and Herzegovina).

## Executive Summary

The global economic crisis uncovered the weaknesses of BiH's public finances and fiscal sector. Before the economic crisis struck, BiH's consolidated budget-- considerably boosted by introduction of VAT in 2006-- resulted in surpluses (it was positively affected by high economic growth, increased investments and remittances). However, BiH's weak economic governance, strongly influenced by irreconcilable political interests, instead of financing true economic growth-enhancing activities used earlier fiscal surpluses for unproductive purposes (e.g. irresponsible/politically motivated expansion of the public sector and increases in public sector wages). These were further compounded with generous social spending that targeted war veterans and other forms of privileged social categories to "buy" their electoral/political support. The sudden contraction of the economy during and following the global financial crisis resulted in declining revenues that forced expenditure cuts impacting budgetary considerations.

The economic reforms implemented during 2006-2010, in which the USAID Mission in BiH had a significant role (ELMO, TARA, TAF), resulted in a gradual reduction of consolidated budget deficits. Although some positive developments over the past several years helped streamline Bosnia and Herzegovina's growing public sector, improving BiH's public finances remains one of the key priorities identified by the USAID Mission, as well as the IMF and EU delegations. Presently, the quality of public finances remains low, even though public financial management was somewhat strengthened. Overall public sector coordination on economic and fiscal policy remains weak, thus impeding systemic reforms. BiH's large and inefficient public sector with multiple overlapping competences at the state, entity, cantonal (in the Federation), and municipal levels continues to impose considerable fiscal risk. The management and structure of public spending in Bosnia and Herzegovina remain fundamental concerns. For that reason, fiscal reporting needs to be improved by enhancing the analytical quality of BiH's fiscal policy design. Structural rigidities such as excessive labor taxation and poorly targeted social transfers need substantive reform to spur labor demand. Additionally, authorities in the Federation should proceed quickly with pension reform.

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*The IMF delegation that held meetings with the BiH Minister for Treasury, Mr. Nikola Spiric on February 25, 2014, again stressed the need for improved fiscal coordination and discipline at all levels of BiH government.*

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As already noted, BiH's public finances is a focus area for the EU. Public Administration Reform, which entails public finance reform in Bosnia and Herzegovina, is necessary for establishing effective, accountable and financially efficient services for businesses and citizens. This reform is a precondition for integration into the EU. The EU *acquis communautaire* considers administrative capacities for

implementation of projects and EU reforms to be one of the most important criteria for EU membership. Although the EU does not prescribe any specific budgetary model, the formation of national and entity budgets is closely monitored and analyzed in terms of capability, proficiency and transparency in management of budget funds. There are two major chapters in the acquis that evaluate BiH's fiscal capacity to join the EU:

1. Chapter 17 of the EU acquis, concerning macroeconomic policy (fiscal and monetary policy), requires mid-term fiscal programming, and monitoring and evaluation of budgetary system results according to the Support for Improvement in Governance and Management (SIGMA) approach. SIGMA is a joint initiative of the European Union and the OECD that works with EU aspiring countries on strengthening public governance systems. SIGMA uses a comprehensive set of measurements to evaluate the quality of budget legislation, budget scope, medium-term expenditure framework, budget management of public investments, and budget execution, monitoring, accounting and reporting.
2. Chapter 32 of the acquis relates to the adoption of internationally agreed upon and EU-compliant principles, standards and methods of public internal financial control (PIFC), which essentially need to be in place to ensure transparent use of public funds.

As further reform of the fiscal sector is key for BiH's sustainable economic growth, particularly given its decreasing revenues and diminishing budgets coupled with excessive government expenditures, USAID decided to design the Fiscal Sector Reform project. This comprehensive project will address the issues summarized above in the following matter:

1. An absence of national coordination of economic and fiscal goals has led to increased independent activities of the two Entities and Brcko District. These uncoordinated actions negatively affect fiscal and tax harmonization within BiH. They further negatively affect the creation of a single economic space by discouraging potential investors, who demand stability and harmonization at the country/sovereign level. The Fiscal Reform project will address these issues through capacity building with the Fiscal Council at the State level, and analytical units of the two Ministries of Finance at the Entity level, to increase their analytical expertise, introduce international standards, improve their coordination and create a common fiscal framework in which BiH's public finances need to operate. (see under A.1)
2. To ensure a more efficient and transparent management of public funds, BiH's treasury operations has to rely on real-time IT business transactions that include all budget users in the FBiH and the RS. This project will incorporate currently outstanding municipalities in FBiH's treasury system; upgrade the current IT system of all Cantons and explore the possibilities for creating and expanding the existing infrastructure for integration and consolidation of the existing and planned IT systems in Federation (BMIS, Treasury, etc.); and integrate RS's Health Sector transactions into the treasury system. This should significantly improve management of BiH's public funds in both entities. (see under A.2)
3. Public Internal Financial Control is a precondition by the EU, described under Chapter 32 of the EU acquis. Public Internal Financial Control (PIFC) in Bosnia and Herzegovina (BiH) is still in the early stages of development. The State (BiH State), the Federation (FBiH) and Republika Srpska



(RS) are basically at the same stage. They coordinate technical development of legislation and methodologies through the Coordination Board (CB) for Central Harmonization Units (CHUs). According to the SIGMA PIFC report for 2013 “FBiH arguably has the most challenging environment, which requires developments to be negotiated through government at the entity, canton and municipality levels”. USAID will work with the Entity Ministry of Finance to introduce the PIFC standards in entity institutions. USAID will also help in training and certification of the auditors. This will ensure increased transparency and internal control over the expenditures from the EU and all other funds. (see under A.3)

4. BiH still lacks a fully integrated public sector IT system for debt management. The State, two entities and Brcko district are using independent, old Access databases to record and trace external debt, while internal debt is recorded in Excel files. These are highly inaccurate and unreliable manual methods of recording and reporting on public debt, as they are often exposed to data input mistakes. Public debt risk management and analyses are very poor. To address the current situation, USAID will help the State and two Entity MoFs to implement a state-of-the-art IT system for debt management. Options would include off-of-the-shelf systems that incorporate best experiences and practices in managing public debt. The system will be tailored to accommodate the specific requests of BiH’s public governance. (see under A.4)
5. To address the issue of diminishing public revenues, USAID will assist the FBiH Ministry of Finance and the FBiH Tax Administration to address tax evasion by helping establish an enforcement mechanism for debt collection from non-complying companies. The effort will focus on the gaming industry in FBiH, which is currently not adequately regulated. Due to weaknesses in tax administration, large amounts of taxes are being evaded every year in this sector. It is anticipated that this activity will increase public revenues from direct taxes by 20-30 million KM annually. (see under A.5.1)
6. The second tax-compliance related activity will target companies that evade publicly mandated collection of debt by transferring money through multiple bank accounts. USAID will assist the FBiH MoF to implement the Single Registry Account IT solution that will register and link all bank accounts for all companies allowing for the “freezing” of bank accounts until the total debt collection is settled. An additional increase in revenue collection can be realistically expected from this intervention. (see under A.5.1)
7. In order to improve the business environment in FBiH, USAID will continue the reform initiated under the TAF project to simplify payroll processing for the private sector. The ultimate goal is to reduce the number of payment orders required for payroll processing down to one. This will result in savings estimated at 24 million KM for employers. (see under A.5.2)
8. To improve the business environment, increase transparency and reduce errors, USAID will assist the RS and FBiH MoFs to further improve tax related IT systems for direct taxes. This reform anticipates introduction and expansion of the E-services related to direct taxes, and expansion and sophistication of the existing IT platforms in two entity TAs. (see under A.5.2)
9. Cantonal and municipal councils in both entities often impose a number of fees and taxes on cars, incomes, etc., that are earmarked for financing community infrastructure such as water systems, education centers, sports facilities, and cultural venues. Often, the destination of the proceeds is off-budget, and the legality of these impositions and the transparency on the use of

such resources are questionable. These para-fiscal taxes (AKA nuisance fees) are unsystematically imposed on all businesses without any clearly defined criteria. In order to increase the legitimacy of such taxes, strengthen their compliance with local tax regimes, enhance fiscal transparency, improve the business environment, and ensure their productivity, these fees/surcharges should be thoroughly reviewed, streamlined, and made explicit in the budget. The establishment of Registers for para-fiscal taxes is a very common practice for addressing this problem. USAID will assist Entity governments to adopt a systematic approach to resolving the issue of nuisance fees and, thereby, improve the local business enabling environment. (see under A.5.3)

## Relationship to the CDCS, and applicable agency policies

**U.S. Mission Strategic Plan.** The 2012-2016 CDCS for the US Mission in BiH identified economic growth and the strengthening of economic aspects of governance relevant to the business environment and private sector development as key foreign policy priorities for the United States Government (USG) in the country.

**Development Objective and Crosscutting Linkages.** The proposed Fiscal Sector Reform activity, that will be implemented under this PAD, Improving Economic Governance (IEG) Project, is designed to address critical needs identified in BiH's CDCS. The overarching objective of this economic development project will indirectly address a number of crosscutting initiatives: 1) inter-ethnic reconciliation by supporting state and entity-level economic institutions that promote a single economic space through regulatory and legislative harmonization; 2) improved business enabling environment; and 3) anti-corruption measures by eliminating nuisance regulations, simplifying procedures, and reducing opportunities for regulatory abuse that deter private sector development.

The activity will also leverage USAID funded projects for strengthening BiH's Parliament(s), and the relevant departments from the US Embassy in Sarajevo (Economic and Political Sections) to facilitate rapid and smooth adoption of the regulations and policies targeted by this project.

**Linkages with the Results Framework.** Development hypothesis: *"An economy with competition and based on market forces will result in new and better enterprises and ideas that lead to more jobs and opportunities. Private sector-driven economic growth provides the only means for a country to generate public and private resources it needs to address development challenges on its own and emerge from dependence on foreign aid. Economic growth provides the material basis for progress in all other dimensions of development and long-term stability".*

The planned project falls under Development Objective 2: Economic Growth/Economic Opportunity, as identified in the 2012-2016 USAID/BiH Country Development Cooperation Strategy. The activities that will be implemented under this project will directly support Intermediate **Result (IR) 2.2 "Improved economic aspects of governance relevant to business activity", with a focus on Sub IR 2.2.1 "Regulations and policies which foster a single economic space and private sector development and investment".**

This IR was envisioned to improve business-relevant strategies and policies that will stimulate economic growth and attract investment. Regulatory and policy reform assistance proposed under Fiscal Sector Reform will address harmonization of regulations and procedures in the fiscal arena across Entities.

## USAID Achievements in the Fiscal Sector to date

This section provides a brief overview of USAID funded activities related to the fiscal sector.

1. TAF Project (2010-2013): Completed the efforts for the Unified Collection System (UCS) in FBiH. Implemented regulations and IT solutions for detecting stop-fillers and non-fillers of direct taxes. Introduced a simplified payroll processing IT system by reducing the number of payment orders for the average of 10 orders down to five. Harmonization of Direct Taxation within Bosnia and Herzegovina by focusing on Brcko District as the direct taxation differed there from the entities. New Personal and Corporation Income tax laws drafted and enacted in Brcko District. Development and Implementation of Audit software to automate the taxpayer audit processes and to avoid discretion among tax administration staff in the selection of returns for audit. Developed the Fiscal Analyses Capacity in the RS and the FBiH by providing training on micro-simulation models using internationally recognized STATA software.
2. ELMO Project (2006-2010): Introduction of the Unified Collection System (UCS) in Republika Srpska and FBiH for simplified, one-stop-shop registration/deregistration of employees for taxes and social contributions;
3. TARA Project (2006-2010): Reform of direct taxation in both entities. Harmonization of direct taxes by introduction of the Personal Income tax (PIT) and Corporate Income Tax (CIT) in RS and FBiH, at unified/identical rates. Modernized TAX administration systems. Introduction of the Property Tax in RS, and Brcko District (FBiH delayed the implementation).

## Other Donors in the Fiscal Sector

In addition to the USAID's efforts in the fiscal sector, other donors recognized the importance of the sound fiscal management for the country's economic and political stability.

### European Commission

Given that the economic criteria for integration with the EU is prescribed in the SAA agreement, it is logical that the **EU Delegation to BiH** is one of the major donors in the reform of BiH's public administration, including public finances and the fiscal system. In 2013, the European Commission allocated approximately 47 million Euros for IPA's Component 1, focusing on Transition Assistance and Institution Building. Of that, approximately 1.6 million Euros will be provided for assistance in public procurement reform. IPA projects funded in previous years are listed below:

- IPA 2007 project "Development and implementation of overall BiH PIFC strategy"

designed to strengthen the financial control environment of public administration. It ended in April 2012.

- IPA 2009 project “Capacity building for the compilation of accounting data within the General Government and statistics of public finance.” Its purpose is to support the Ministries of Finance of the State and the Entities and the Brcko District Directorate in providing sound and inter-institutional harmonized data on public finance on the basis of accrual accounting in accordance with international, especially EU principles, standards and practices. It will end in early 2014.
- IPA 2010 project “Coordination of policy making capacities and public financial management” with the purpose of improving the quality of fiscal policy and the links between policy makers and budgeting procedures.
- IPA 2011 fund: EC allocated approximately 4 million Euros for public finance restructuring, and financial management in compliance with EU standards. Component I of the project is related to the strengthening of treasury operations at the level of the state and the entities, and is currently in the drafting phase of terms of reference. (need to verify if some of the funds were cancelled due to failure to implement Sejdic-Finci ruling<sup>2</sup>).

#### PARCO (Public Administration Reform Coordinator’s Office) – Multi Donors

The Government of BiH, through the Council Of Ministers (CoM) and the Public Administration Reform Coordinator’s Office (PARCO), is tasked with implementation of the public administration reform projects. Under PARCO, a Public Administration Reform Fund (PAR Fund) has been established as a source of financing for technical assistance in the implementation of the projects that were defined in the Action Plan (later modified and referred to as the Revised Action Plan – RAP 1). Main contributors to the Fund are international donors and foreign governments: Delegation of the European Union in BiH, Ministry of Foreign Affairs of Great Britain, Swedish International Development Agency (SIDA), The Royal Netherlands Embassy, and Ministry of Foreign Affairs of the Kingdom of Norway. However, the reforms under PARCO are often implemented at a very slow pace and do not meet the expectations of the entity ministries.

#### IMF (International Monetary Fund)

The IMF Mission is a strong supporter of fiscal sector reform. IMF and USAID coordinated their activities in the fiscal arena in past years: USAID’s ELMO and TAF activities (Unified Collection System and Payroll Processing System) were recognized by the IMF as highly important reforms, and were included in the negotiations for the Stand –By – Arrangement with BiH authorities. IMF is presently supporting the adoption of the FBiH Law on budget, and the State Law on public procurement. IMF also strongly supports work of all four Tax Administrations (TAs) in BiH, and conditions further monetary assistance for the country with direct assistance to the TAs.

#### GIZ (German Government)

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<sup>2</sup> Bosnia and Herzegovina failed to secure implement Sejdić-Finci ruling, human rights and electoral rights decision by the European Human Rights Court, and lost 45 million Euros in IPA funds. European Union decide to slash funds for Bosnia and to transfer remaining part to Kosovo which will be used in infrastructure and development programs .

There is ongoing cooperation between the Governments of BiH and the German GIZ project for technical assistance for public administration reform. This project will introduce electronic processing in the public procurement system of Bosnia and Herzegovina.

#### DFID (ended in 2010)

The Project for Strengthening Public Expenditure Management in BiH addressed the process of budget planning and preparation at all levels, and has introduced the process of „Budget Planning in 10 Steps,’ representing basic concepts of program budgeting and strengthened medium term budget planning and preparation.

### **Recent achievements in support of the activity**

1. The new Law on Budgets for the Federation was adopted by the Federation parliament. The law was developed with assistance from the International Monetary Fund (IMF). The law is a critical step for promoting fiscal discipline in the Federation.
2. The IMF, under the Stand-By Arrangement (SBA) approved Bosnia and Herzegovina’s (BiH) request for a two-year SBA. The fourth review was completed in October 2013 after which 125 percent of funds have been disbursed. An additional 25 percent of funds have just become available after the fifth review was completed in January 2014.
3. The BiH government adopted a new draft procurement law for BiH—prepared with assistance from the EU. The new law harmonized local procurement framework with EU standards. The law will be adopted by the BiH parliament in spring of 2014. This directly impacts public expenditures.
4. The World Bank assisted FBiH authorities to develop a new pension system strategy reform. The Federation parliament has adopted the pension reform strategy that is based on increasing the number of contributors and raising the retirement age in order to ensure some sort of long-term viability of the existing PAYGO pension system. The expenditure for social benefit systems is the most critical aspect of public expenditures.
5. The Indirect Tax Authority (ITA) increased its transparency by starting to publish the names of the 100 largest tax debtors. A similar action was initiated in the FBiH where the Tax Administration for direct taxes went public with estimated figures on tax evasions. By increasing transparency, tax administrations are trying to reduce tax evasion and improve revenue collection.
6. The four tax agencies (ITA, FTA, RSTA, and BDTA) will start exchanging taxpayer information in January 2014. The tax agencies are working to complete the legal and technical steps needed to allow for automated and unfettered access to each other’s taxpayer data. This was a joint effort by USAID TAF and US Treasury, and finalized by the IMF. This will improve tax collection and fight tax evasions.
7. The Federation authorities will restart the privatization process with the aim to improve economic governance and encourage private investment. The assistance will be provided by the World Bank and the EBRD to prepare the action plan for submission to parliament by mid-2014 that will specify the candidate companies for privatization. This will provide additional revenues to support FBiH’s economic growth.

## Methodologies

The overarching goal of the USAID/Bosnia and Herzegovina (BiH) 2012-2016 CDCS is to support BiH in becoming a more stable country closer to EU and Euro-Atlantic integration. The economic development objective in the CDCS is designed to create a competitive and market-oriented economy that will stimulate economic growth and improve living conditions for all BiH citizens.

In order to create a competitive market economy, EDO activities in the fiscal sector must focus on supporting harmonization of fiscal policies and procedures between the entities, creating a strong fiscal discipline, and improving fiscal coordination among all levels of the government.

USAID will take a three-prong approach to addressing the needs in the fiscal sector. This comprehensive approach will ensure a high level of coordination among the entities, as well as the horizontal and vertical integration in the fiscal management system. USAID design team believes that the adopted three-prong approach will reinforce the synergy and harmonization between the initiatives proposed under this reform. In that manner, the activities at the State and level of the entities will contribute towards the ultimate goal in the fiscal sector: Improved fiscal coordination, better compliance, more accurate fiscal planning, and standardized and harmonized reporting towards the EU. Provided that Fiscal reform has a cross-cutting effect on all other sectors, and particularly in prevention of corruption, this reform is extremely important in the light of the BiH accession aspirations to the EU. Besides adjusting the BiH legislative framework, improving fiscal discipline and management in accordance with the best EU practices, the reform will directly effect the collection of public revenues by increasing the tax compliance and reducing tax evasions.

1. The assistance will be provided to the State and the two Entity Governments. Higher level of fiscal coordination is expected. Activities described under: A.1, A.2, A.4, A.5.3; are contributing to this goal.
2. A wide range of governmental ministries and institutions will be included in the reforms. Assistance will be provided to State, Entity, and lower levels of government (Federation of BiH). Assistance will benefit public sector institutions, such as entity Tax Administrations.
3. The assistance will address issues related to both public revenues (A.1, A.2, A.3, A.5.1, A.5.2) and public expenditures (A.1, A.2, A.3, A.4). In addition, USAID will improve fiscal coordination and reporting, as well as the business enabling environment (A.5.2, A.5.3) in terms of reducing the time and costs of operating a business in the country.

Given that assistance will be provided to both entity governments, one must take into account their different levels of fiscal maturity. Having a more complex administrative structure, the Federation of Bosnia and Herzegovina is lagging in fiscal reform implementation relative to the Republika Srpska (ca., a 2 to 4 years lag). Therefore, different kinds of assistance will be provided to the respective entities. In order to support the idea of a single economic space in BiH more assistance will be provided to FBiH.

The assistance provided under this project will range from short-term (estimated at around 12 to 16 months), which is expected to bring visible results and quick improvements to regulations, procedures and processes, to long term assistance, which will focus on more complex activities, such as reform of the public internal control, as well as other activities that require continued technical assistance and capacity building in accordance with the best EU practices and standards (around 3 to 4 years). Lastly,

the Mission's budget constraints had to be considered when prioritizing among the viable options for USAID assistance. Given that the budgets for individual activity components are rough estimates, further scrutiny and prioritizing is possible.

All activities to be implemented under this activity are or will be coordinated with the relevant local authorities and international donors: Council of Ministers, Ministry of Finance and Treasury at the State level, PARCO, Entity-Ministries of Finance, European Commission, IMF, etc.

Proposed activities are coordinated with the PARCO Strategy of public administration reform, a document which contains guidelines for strengthening general administrative capacities of the government, and in consultations with the relevant ministries in both entities. Operational implementation of the PARCO Strategy is regulated by its Revised Action Plan 1, with precise deadlines and institutions in charge of the building, strengthening and harmonization of general systems in six reform areas, of which Public Finances, Information Technologies, and Policy and Coordination Capacities were selected for EDO's assistance.

## Illustrative activities

### A.1. Assistance for the Fiscal Council

Beneficiary: State of BiH (Council of Ministers, Fiscal Council), FBiH, RSBiH

Focus of assistance: Macroeconomic policy, fiscal discipline

One of the most significant public finance reforms implemented so far only at the State level was the introduction of a supreme policy coordination mechanism in BiH - the Fiscal Council (FC). The importance of the FC given BiH's complex public administration structure is crucial. The high degree of fiscal interdependence among BiH's multiple levels of government required fiscal coordination by a state level mechanism. Also, the EU negotiation process recognizes only one principal sovereign interlocutor, in order to command better coordination among BiH's multiple levels of government in all areas, including the fiscal sphere, for prompt implementation of the acquis. Hence, the international community insisted on establishment of the FC. The FC was established in 2005 at the state level, but became operational in 2008 only after the negative fallout from the global economic crisis that started to affect BiH's economy.

The main task of the FC is formulation of fiscal policy objectives. FC adopts a medium-term fiscal policy framework, which includes the fiscal goals of the State, Entities and the District, macroeconomic projections, and projections of indirect taxes and overall expenditures. The necessary decision-making information for members of the Fiscal Council includes two analytical tools: a macro-fiscal framework and a consolidated government account. The Fiscal Council is in charge of BiH's Global Fiscal Balance and Policy Framework.

Recent developments related to the FC are positive: The Ministry of Finance and Treasury of BiH prepared and proposed to the Fiscal Council the Global Framework of Fiscal Balance and Policies in BiH for 2014 – 2016. Its adoption is pending. (need to check if approved by now). The adoption of the

Global Framework for Fiscal Policies will facilitate the timely preparation of public sector budgets. The authorities also plan to implement a number of measures regarding standardized fiscal statistics and harmonization of different budget reporting methodologies, both of which will increase the transparency of fiscal policy and strengthen fiscal analytics.

The Fiscal Council has six members: the Chairman of the Council of Ministers and Prime Ministers of the Entities, as well as the Entity and State Ministers of Finance. The Governor of the Central Bank and a representative from the Brčko District Government are observers in the Fiscal Council. Decisions of the Fiscal Council are adopted by a majority of five votes. In the case of disagreement on the fiscal framework, the different levels of government are required to submit a proposal for interim financing based on the previous year's budget level. In the event of the budget exceeding the previous year's level, the government that violated the budgetary framework should transfer 10% of the overrun at the expense of special purpose funds from which the repayment of internal debt of the government is financed.<sup>3</sup>

Weaknesses/Needs: The existing model of fiscal coordination has substantial weaknesses. The technical effectiveness of the FC is seriously diminished by inclusion of the entity Prime Ministers in the FC, as it opens a door for political agendas and debates. Cantons, municipalities and extra budgetary funds are excluded from the coordination system. The sanction mechanism is weak and represents only 10 % of the excess money for internal debt. FC member responsibility and/or penalties are not regulated, despite this being a standard element in fiscal coordination in other countries. There are different statistical methods in place for fiscal reporting purposes in the entities, where capital expenditures and receipts are not taken into account. The capacity for macroeconomic modeling is very weak at all levels of government. (State, Entities)

Illustrative activities include but are not limited to:

- Analysis of the current Law on FC: Identification of strengths, weaknesses, opportunities and threats (SWOT analysis)
- Drafting amendments to the Law on FC and relevant corresponding entity legislation to address the following issues: 1. Budget impasse due to non-adoption of Global Framework on Fiscal Balance; 2. Adoption of more rigorous penalties for non-compliance; 3. Reporting based on the same inputs, e.g. inclusion of capital expenditures in the consolidated expenditures should be a shared practice by both entities.
- Strengthen the formal internal technical support structure for the FC and the two entity Ministries of Finance in the areas of macro-economic modeling. Support the analytical unit (advisory unit) under the authority of the FC, and provide technical assistance/training to the selected staff from the two entity MoFs. (Macroeconomic models are numerical representations of economic theory, intuition and data). Provide technical assistance to strengthen the analytical and reporting capacity of the Fiscal Council to harmonize statistical methods and reporting between the entities. Provide capacity building/training for the relevant authorities (Ministries of Finance at State, and entity levels). Explore possibilities for

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<sup>3</sup> Dinka Antić: multi-level fiscal system in Bosnia and Herzegovina: evolution and coping with economic crisis



establishment of the entity FCs (workgroups) and assist them to select appropriate macro-economic modeling approach..

- Work with the FC to re-shape the public revenues and expenditures by increasing efficiency of spending and by achieving reductions in labor taxes (find fine balance with benefit reductions or replace labor taxes with other revenue resources.) Improving revenue efficiency, by implementing changes in the indirect taxation system and in the customs policy. Although the EU Country reports repeatedly stress the labor rigidities associated with the high labor taxes (contributions) as one of the main obstacles for economic growth, this issue is not addressed at all by the entity governments. The FC can be an efficient mechanism for addressing this issue.

#### Expected Results:

- Result 1: Analytical input supporting legislative improvements
- Result 2: Amended or eliminated ineffective regulations/procedures of the FC, which will result in more efficient work of the FC
- Result 3: Reporting of public finance statistics harmonized between the entities, which will result in more transparent, accountable, and consistent reporting to the EU. The accounting standard harmonized, implemented and adopted for the purpose of FC reporting.
- Result 4: Analytical capacity of the FC, FMOF and RS MoF strengthened, which will result in fiscal policies, budget planning and reporting in accordance with the EU standards. Harmonized Macro-econometric models adopted and implemented at State, and the level of the entities.

## **A.2 Strengthening of the FBiH Treasury System**

- Beneficiary: Federation of BiH (Cantons and municipalities);  
Republika Srpska (Health Sector)
- Focus of assistance: Public revenue/expenditure, fiscal discipline

US Government has a long history assisting BiH's Treasury system (TS). The first intervention efforts started back in 2000 with the USG (USAID and US Treasury) dismantling the Payment Bureaus (PB). The TS system was introduced immediately after that as a replacement for the socialist legacy PBs.

Created by the US Treasury and supported by USAID, the establishment of the treasury business operations was conducted in phases. In the Federation (FBiH), the treasury system was implemented at the Cantonal level, while Republika Srpska (RS) expanded the process of introducing local treasuries to include municipalities and cities. An identical Oracle platform was used in both entities. Since then the treasury system was introduced at several levels of government administration and budget planning. This was a productive intermediate step. However, TS still does not cover all levels of public administration. The situation is particularly ineffective in the FBiH, where the vast majority of municipalities operate outside the TS system. Since TS is a service encompassing all public administration and important in formulating entity budgets, it is paramount that it integrate all levels of public administration and budget planning without exceptions.

Weaknesses/needs: Entering of transactions for budget users that are currently outside the system is done by filling in paper forms. This is a slow, non-transparent process of reporting, open to mistakes and delays, particularly when preparing consolidated statements. Therefore, it is necessary to expand the

treasury business operation and the real-time IT system to all budget users of the FBiH and RS institutions to offer them a more efficient and transparent management of public funds.

As mentioned earlier, the situation is more ineffective in the FBiH. USAID funded GAP II project introduced the treasury system in 19 municipalities in the FBiH. However, a vast majority of FBiH's municipalities are still outside the treasury system. (Some estimations show 50-60 municipalities out of 80 in FBiH). The EC evaluation of the TS system showed 42 budget users of FBiH and 30 budget users of the Institutions of BiH are not connected on-line with the State Treasury of the Ministry of Finance and FBiH Treasury and Ministry of Finance. The EC IPA 2011 reserved the funds for the strengthening of treasury operations at the state and entities, and is currently in the drafting phase of terms of reference. The EC project is also financing the Disaster Recovery Center for data protection at the State and entity level. The EC also funded the expansion and completion of the TS system in the RS: The final stage of the TS development in the RS included the last 25 municipalities and the city of Istocno Sarajevo. Although more work was accomplished in Republika Srpska, there is still a lot that needs to be done since extra-budgetary funds remain outside the TS system.

Urgent assistance is needed for completion of the TS system at lower levels of the FBiH government. Furthermore, simplification of the FBiH TS system should be explored, given that Republika Srpska has a total of three IT treasury related -systems, while FBiH, according to the should have a hundred IT treasury systems (provided that each municipality will have its own decentralized system). Simplification and centralization of the FBiH system seems like an obvious solution for the sake of harmonization between the entities, and for reduced costs related to implementation and maintenance. Furthermore, a higher degree of horizontal and vertical integration of the independent IT systems in FBiH is required. Synchronization of the IT systems that are deployed for individual institutions must be addressed, particularly in case of the TS and BMIS. In Republika Srpska, assistance will be provided to incorporate the Health Sector into the treasury system.

Illustrative activities include but are not limited to:

- Updated analysis of the present state of the TS system at the lower levels of governance in FBiH, identifying issues and weaknesses and focusing effective solutions on Cantons and municipalities. Implementation of the most viable solution for improvement of the TS system in Cantons and municipalities.
- Explore and document possible integrations between the individual IT systems in connection with public finances in FBiH. Deploy BMIS at the lower level of FBiH administration and identify possibilities for common synergies between TS and BMIS IT systems.
- Analysis of the business requirements for inclusion of the RS Health Sector into the Treasury Operations System, and the implementation of the TS system in RS Health Sector

Expected Results:

- Result 1: Analysis produced, recommending the most viable solution for TS system in Cantons and municipalities. Reduction in cost for maintenance and upgrades achieved.
- Result 2: Up to 60 municipalities in the FBiH included in a real-time treasury system. Upgrades to the IT system(s) in 10 Cantons in the FBiH. Independent IT systems related to public finances consolidated and integrated.
- Result 3: Health sector budget users in RS included in the RS Treasury System introduced in RS Health Sector

### A.3 Strengthening of the Public Internal Financial Control (PIFC)

Beneficiary: Federation of BiH

Focus of assistance: Public Administration/Fiscal discipline/ internal control

Chapter 32 of the EU acquis requires adoption of internationally-agreed and EU-compliant principles, standards and methods of public internal financial control (PIFC), which essentially need to be in place to ensure transparent use of public budget funds. Since the EU provides funds for the development of the member and candidate countries, it expects their use to be subject to adequate inspections, independent audits, and effective coordination and reporting in a centralized manner. These are also the three pillars of the strategy for introduction of PFIC at the state and the two entities (inspection and internal control, audit, central harmonization unit). The introduction of a PIFC system is usually based on: adoption of policy papers; adoption of PIFC legislation; designation of a central harmonization and control body/unit (CHU) for PIFC; introduction of an internal audit service to the public sector; and the introduction of sound financial management and control systems.

Within the Public Administration Reform (PAR) framework (implemented through PARCO) BiH is obliged to introduce PIFC systems that will be harmonized across the different levels of government. The policy paper on PIFC introduction has already been drafted by FMOF, outlining the elements of the PIFC system. Additionally, the CHU is presently being established. According to the FBIH Strategy for PFIC, there are 1420 budgetary users that will be included in the PFIC system. This will be accomplished through an estimated 144 units for PFIC, of which approximately 60% has been established already. The principal instruments of PIFC for BiH State and the entities are their real time electronic treasury systems (TS), so this activity is closely tied to the one introducing the real-time treasury systems in both entities. Each system has two functions. One is that of a cash management system, which among other things provides daily bank reconciliations. The other is that of a cash control system, which ensures that budget users do not exceed cash expenditure allocations. In the latter respect the systems appear to be working well in controlling expenditure and in ensuring effective cash flow management.

Weaknesses/needs: Further strengthening of the PIFC system in FBIH will address key functions in financial management at all government levels in FBIH. Presently, the internal controls system are not satisfactory and further improvements are necessary to introduce a system of public internal financial controls based on the three pillars. The internal controls system should be further developed in a way that would enable the control of the purposeful use of public funds. A large number of institutions do not currently have the internal audit functions defined within their rulebooks.

Illustrative activities include but are not limited to:

- Analysis of the current stage of PFIC implementation in FBIH
- Work on institutional and organizational frameworks with clear definition of duties and procedures, and introduction of independent internal audit functions
- Capacity building activities for the staff in CHU

- Technical Assistance for the managers are directly responsible for establishing of internal control and internal audit procedures in public institutions

Expected Results:

- Result 1: Improved regulations and procedures for PFIC at the level of FBiH in accordance with the EU standards
- Result 2: System for internal financial control implemented in the FBiH institutions
- Result 3: Technical capacity of the responsible managers improved
- Result 4: Technical capacity of CHU staff developed

**A.4 Strengthening of the Public Debt Management**

Beneficiary: State, FBiH, RS

Focus of assistance: Fiscal Sustainability – Debt Management

The Public debt portfolio is of a great importance for the fiscal stability of the country and the two Entities. It is imperative for all countries, and particularly transitional ones, to develop good debt practices and risk management to reduce the vulnerability of the domestic economy.

According to the Central Bank of Bosnia and Herzegovina in 2013 the country recorded a Government Debt of 43.80 percent of the country's Gross Domestic Product (GDP). This represents a moderate level of public debt. In the structure of the total public debt, approximately 68% is the external debt where the major creditors are the "low interest rate" financial creditors, such as the IMF, World Bank, and EBRD. The external debt amounts to Euro 3.7 bn, or 28% of the GDP. The internal debt represents 32% of the total debt, where most of it is the pre-war debt (old currency savings), and war claims.

Bosnia and Herzegovina's external debt is projected to drop to an estimated 22.3% of GDP in 2015. The currency structure of external debt is relatively favorable, since 46% of the outstanding debt stock is denominated in EUR. A large part of the debt stock has been contracted with the average interest rate of less than 2%. The internal is also projected to decline to 8.6% of GDP in 2015. (these seem like very optimistic forecasts).

Given BiH's increasing deficit since 2006, when the country reported a record low debt to GDP of 21.8%, BiH undertook steps to improve its management of public debt over the past few years. The complexity of BiH's public sector institutional set-up has caused different degrees of decentralization of public debt management: In terms of external borrowing, the decision about borrowing is regulated by the Constitution of BiH, the Entities' Constitution and relevant state and Entity laws. The initiative for borrowing can be made in the Council of Ministers. The internal debt is decentralized and is under the competency of each government level (entities). Cantons and municipalities are, in principle, free to borrow, but approval procedures differ from Canton to Canton and depend on the purpose of borrowing in the RS.

Weaknesses/needs: Bosnia and Herzegovina does not have an overarching system for public debt management. The State, two entities and Brcko district are using independent, old Access databases to record and trace the external debt. The internal debt is recorded in Excel files. Risk management and analyses are very poor. In 2012 the World Bank deployed an expert team to BiH to analyze the current state of its debt management systems. The WB findings confirmed the above statements and recommended introduction of a Debt management IT system (DMS). The WB recommended one joint IT system, but also provided the option of four IT DMS systems. The EC is implementing a project that will provide capacity building and knowledge sharing about debt management. The EC will also finance the analysis of the needs for further improvement of the debt management processes at all levels of government.

So far, BiH has established a relation with the United Nations Conference on Trade and Development (UNCTAD). UNCTAD is the forum for sharing experiences among Governments, international organizations, on current developments related to debt and debt management. As such, UNCTAD has a technical department for development and implementation of the debt management solutions. UNCTAD has offered technical assistance to BiH, which would include a free Debt Management software solution called DMFAS (Debt Management and Financial Analyses System). The cost for implementation of this system would be minimal, and would include the advisory cost for additional analysis of business requirements, software installation and minimal training hours. However, other options are also possible, such as CS-DRMS (Commonwealth Secretariat- Debt Recording and Management System) or DSM+ (Debt Sustainability Modell Plus).

Illustrative activities include but are not limited to:

- Finalize the discussions with the BiH authorities (State, Entities) for viable IT solution for debt management (Focus on DMFAS system for being free of charge, and for the fact that provisional agreement with UNCTAD already exists)
- Assist BiH authorities in implementation of legislative and procedural changes
- Assist UNCTAD in defining business, administrative and legal requirements for the new system at all levels of governance
- Assist UNCTAD in implementation, expansion and modification of the system to cover all levels of the government based on the EC analysis and WB recommendations.

Expected Results:

- Result 1: Selected the most viable solution for the public debt management system for all levels of the government
- Result 2: Legislation and procedures improved to enable efficient DMS installation
- Result 3: DMS system installed at all levels of the government (State, both entities) using appropriate tools and techniques to manage and use the best methods and procedures for debt management. The IT solution will increase analytical capability of the three MoFs in debt management and debt reporting. It will also Increase the accuracy in the public debt reporting process.

## **A.5 Increased compliance and improved business environment**

### **A.5.1**

Beneficiary: FBiH Ministry of Finance (Tax Administration)

Focus of assistance: Tax compliance – reducing tax evasion

To increase the tax compliance and improve public revenue collection, EDO will implement two initiatives: The first one will address the widespread tax evasions in the gaming industry in the Federation of BiH: the estimated losses in tax revenues from this industry are staggering. In addition, it seems that this industry has strong supporters in the FBiH Parliament, and international community, which may indicate possible corruption associated with the sector. The second initiative will also improve the public revenue collection through increased transparency in business operations of locally registered companies: the activity will establish the register of business accounts in order to facilitate debt collection.

According to the statement provided by the Director of the FBiH Tax Administration (FTA) Mr. Midhat Arifovic provided to the local press in 2013, FBiH is annually losing an estimated 400 million KM due to tax evasions. Although the Federal Ministry of Finance and Tax Administration are placing great efforts on tax compliance, large amounts of taxes are being evaded every year. The FTA considers enforcing of tax compliance as one of its top priorities in the next period. These efforts by the FTA were recognized by the IMF, which strongly advocates for technical assistance to the FTA. One of the critical areas that requires additional strengthening, through increased control and supervision, is the gaming industry in FBiH.

Weaknesses/Needs: Tax regime for the gaming industry in FBiH is very poor. There is no effective taxation of incomes and profits from gaming activities. Given that the industry is not effectively taxed by the TA, taxation is done based on the amounts submitted by the companies. Recently, the FTA analyzed the tax reports submitted by the companies and evaluated them against analysis and estimates produced by the TA: FTA estimates that in the past ten years since passage of the Law on Games of Chance, FBiH has lost between 250 million KM (low estimate) to 500 million KM (high estimate). To increase direct tax compliance, reduce corruption, and increase collection of public revenues, the FMoF and the FTA have stated their strong interest to address the pressing problem of tax evasion in the gaming industry.

Another issue is related to the inefficient forced collections of company debts through bank accounts. To avoid the forced collection on unpaid obligations, BiH companies tend to open several bank accounts that are not connected to a main bank account. When the forced collection is initiated, the main account is frozen, but the companies continue to operate using other bank accounts that remain outside the TA's control. Republika Srpska resolved this issue by introducing the new Law on Internal Payments Operations (IPO). The Law was adopted in 2012, and it stipulated that all orders for forced collections must be made from the main bank account of the business entity, and in case of insufficient funds, the authority (bank) responsible for the main account must send requests to other financial institutions (banks) to freeze all other bank accounts associated with the debtor, until the total debt is settled in the main account. All other payments are prohibited until the debt is settled. Only after settlement can the

company bank accounts be unfrozen and new accounts opened. A similar solution is needed for FBiH, and it must be incorporated into the existing payment system to include all commercial banks. To accomplish this reform a Single Register of Business Accounts must be established in FBiH: The register will compile all bank accounts for all companies operating in FBiH. The Federation of BiH already drafted and adopted a new Federal Law on: Internal Payments Operation IPO. Technical assistance will be required to establish the Single Registry and define procedures for information sharing and freezing accounts.

Illustrative activities include but are not limited to:

- Analysis of the current condition of the gaming industry in FBiH, including legislative deficiencies, number of companies, detailed analysis of tax reports and real taxable incomes, number, type and producers of gaming machines most frequently in use in FBiH;
- Analysis of the present legislative framework and system of controls; Recommendations for improvement of the sector, Best practices from the region;
- Design and implement the IT solution for improved taxation of the gaming industry: System tying gaming machines online with the FTA;
- Assistance for MOF for establishment of the Single Registry for Business accounts

Expected Results:

- Result 1: Report on the current condition of the gaming industry in FBiH
- Result 2: Report on the required legislative and procedural changes for increased tax compliance
- Result 3: IT system for improved tax compliance implemented in the FBiH
- Result 4: Revenues collected from this intervention are estimated at 20-30 million KM annually (conservative estimate)
- Result 5: The Single Registry of Business Accounts established and deployed in commercial banks in FBiH, resulting in increase of 5% in the forced collection of company debts in the year following the implementation.

**A.5.2**

Beneficiary: FBiH Ministry of Finance; (Tax Administrations);

RS Ministry of Finance (Tax Administration)

Focus of assistance: Business environment

The activity is aimed at further enhancements based on the existing IT platform developed and implemented for the Unified Collection System (UCS). In the Federation, the activity will focus on further simplification of direct taxes payments by reducing the number of payment orders an employer

must prepare in order to process payrolls, and enabling of the on-line filing of direct taxes (payroll related taxes at first, followed by expansion of the system to include car registration, and other fees).

USAID TAF reduced the number of payment orders for payroll processing from ten to five separate payment orders, one for each of extra-budgetary funds (3), and the remaining two for personal income tax and para-fiscal charges associated with the payroll. The system, designed by USAID, will ensure that the Federation level social funds will perform the reconciliation based on place of residence to Cantonal funds, while the Cantonal treasuries will perform the reconciliation and distribution to cantons and municipalities. As a result, the requirements for businesses to pay bank fees and the time needed to fill out the payment orders will decrease by 44% in average, and the number of payment orders will be reduced by half. The proposed system for payroll orders will require significantly shorter time for processing; reduce the associated costs for bank fees, and significantly improve the BiH's World Bank Doing Business ranking in taxing, and consequently attract desperately needed foreign investments.

USAID drafted the required regulation amendments to implement the new system, and completed the software development for public revenue distribution to end-users. The software was delivered as a standard Windows application and runs on a system platform: as new payment data are received, the software calculates the distribution and issues payment orders. User interface is used only for administration.

In order to implement the payment simplification software, the TA database should be accurate and current. The information provided on the Monthly Payroll Report (MIP) forms are crucial for the proper implementation of the payment simplification software. The MIP Form includes data on a monthly basis for each employee on paid salary, contributions and taxes paid. During the Payment Simplification Software development process, TAF uncovered a problem related to the submissions of MIP-1023 forms. Using previous payments as test data, TAF uncovered that some taxpayers submit MIP-1023 inconsistently from month-to-month. Payments differ from month to month. Since there is no consistent taxpayer practice, it is not possible to calculate payment distributions automatically. Implementation of payment simplification software under these circumstances could cause severe problems to taxpayers, the TA and to beneficiaries of the social benefits. Therefore TAF proposed to postpone the implementation of an already developed payment simplification software after the quality and timeliness of MIP forms filing significantly improved.

The TAF Team worked closely with the FBiH Finance Ministry to improve filing and processing of MIP forms since these forms are the basis for the data to be used in the new software. Improvements in the MIP submissions will have a significant positive impact on citizens by ensuring timely and accurate information on which to base the employee's social contributions. The TAF IT staff identified the main problems with the MIPs, which remain significant obstacles for software implementation. The anticipated timeframe for completion of the MIP process improvement is end of 2014.

This activity will build on the achievements of previous USAID projects to complete the simplification of the payroll processing, by further decreasing the number of payment orders required for payroll processing to the ultimate number of just one payment order. This will significantly benefit BiH's



business enabling environment by reducing the costs and time of doing business. (USAID estimated 24 million KM annually will be saved for businesses, and 4 million of man-hours for accounting purposes). The importance of the reform was recognized by the IMF, and it was included in the SBA negotiations with the FBiH government.

Also, EDO will improve the business environment in FBiH by strengthening the capacity of the on-line tax filing system (e-services) in both entities. This system will include not just the filling of the payroll and contribution taxes, but also all other direct taxes. The system will be highly automated and it will eventually replace the manual tax fillings generated by hand. The system will use the modern IT solutions, such as Cloud and Mobility to simplify and speed up registration and tax fillings. This will result in additional savings in time and money for both employers and Tax Administrations. This will be a clear benefit for all tax payers, and it will also contribute to the establishment of e-governance, and the single economic space.

Illustrative activities include but are not limited to:

- Analysis of legislative framework required for further payment simplification and introduction of one payment order system. Legislative advocacy in form of the in-depth explanations of the system for members of the FBiH Parliament and Cantonal governments; Work with reform champions (FBiH Association of employers and Foreign Investors Council) to promote the reform; Lobbying with the FBiH Parliament for a prompt adoption of the one-payment system;
- Modification and installation of the IT system which will accommodate one payment order payroll system;
- Analysis of the requirements for more efficient on-line tax filing (e-registration, e-certificates, etc.); Design and implementation of the IT system that will accommodate on-line filing

Expected Results:

- Result 1: Simplified payroll processing for businesses in FBiH that will significantly reduce time and cost of doing business (TAF estimate 24 million KM annually; 4 million men-hours for filling payment orders will be saved);
- Result 2: Better business environment created for investors;
- Result 3: IT system enabling e-services for filling of taxes implemented in RS and FBiH;
- Result 4: Cost savings for employers and administration estimated at an additional 20 million KM (FMoF estimate);
- Result 5: Increased transparency and reduced chances for mistakes due to automated processes.

### **A.5.3**

Beneficiary: FBiH Ministry of Finance

RS Ministry of Finance (Tax Administrations)

Focus of assistance: Business environment – elimination of nuisance taxes

A fewer, well-targeted and legally justified local fees/surcharges are more effective instruments in terms of budget financing and community life improvement than huge number of taxes randomly imposed on all businesses (e.g., environmental control, infrastructure reconstruction, improved water treatment, and sanitation). Therefore surcharges, fees, and user charges are suitable additional instruments to provide local governments with a meaningful degree of tax autonomy on the revenue side of the budget.

This component will follow regional examples for creation of a better business environment by eliminating para-fiscal/nuisance taxes that are burdensome for the private sector. In the last couple of years, the international community (EU Progress Report, Foreign Investors Council, USAID as well as Associations of Employers in both entities) was repeatedly stressing that radical reforms are needed to transform the current business-unfriendly environment that repels foreign investors and is highly unfair to private companies operating in FBiH. This is becoming increasingly important provided that other countries in the region have already initiated such reforms, and BiH continues to lag behind: efforts were launched in 2013 by USAID Mission in Republic of Serbia that eliminated 108 para-fiscal taxes for businesses. Republic of Croatia has started activities to improve the business environment as well, targeting the para-fiscal fees for forests (possibilities to eliminate/reduce the forest environmental tax that is currently applied to all economic activities at the rate of 0.07% of the service value), and tourism (based on survey that showed that higher tax burden reduces hotels and tourism revenues, while the increase or decrease of tax rate significantly influences the decisions of the tourists regarding the destination of a travel, the country is trying to reduce the hidden hotel taxes. In Bosnia and Herzegovina, both entity governments recognized the importance of transparent and investor-friendly procedures for economic growth. Creating better business environments by eliminating cumbersome and costly procedures and taxes will enhance the environment for foreign direct investments (FDI). Republika Srpska (RS MoF) is presently finalizing a strategy for elimination of nuisance taxes (according to our source in the RS MoF the strategy will be completed this summer). The FBiH MoF drafted several amendments to existing legislation related to its tourism, water and forest fees, and their adoption is presently being debated. However, more assistance is needed to determine all charges that are presently being imposed on businesses in the country. This is particularly hard in FBiH where all levels of government (Entity, canton, municipality) have the authority to charge para-fiscal fees. In order to improve the business environment and reinforce the idea of a single economic space in BiH, further assistance is needed for both entity governments to reduce the number of fees applied unselectively to companies, and to harmonize para-fiscal fees.

Illustrative activities include but are not limited to:

- Assist FBiH to analyze the existing legal framework that is hindering new investments at all levels of government (Entity, Canton, municipality);
- Establish the Register of para-fiscal charges in Republika Srpska and FBiH;
- Draft legislative amendments to improve the relevant legislation and eliminate burdensome fees;
- Assist different levels of local government to replace the lost revenues by identifying other more productive and investor-friendly sources of revenue.

### Expected Results:

- Result 1: # of nuisance fees eliminated /reduced in both entities
- Result 2: Fiscal stability of different levels of local government preserved
- Result 3: Cost and time for business operations in FBiH reduced
- Result 4: Harmonization between the two entities in the area of para-fiscal fees achieved

## **Monitoring, Evaluation, and Learning**

Monitoring and evaluation of performance and impact will be a collaborative process with the participation of the project implementer(s), USAID, and the third party (M&E contractor). USAID will conduct a third party performance evaluation; the evaluation will be conducted to evaluate activity performance and to ensure that the approach is relevant to the current context.

USAID will monitor the impact using the approved project-level (see attached Annex X) logical framework that provided basic guidance for project monitoring and evaluation. For the Fiscal Sector Reform Activity, Project Design Team in cooperation with a third party contracted under the M&E award will develop an activity-specific indicator named Economic Governance Index (EGI). This indicator will be tailored to aggregate and analyze outputs from the individual sub-activities implemented under this reform, and place them in a context of the overall achievement towards the DO Purpose and Goal. The overall EGI indicator will have to provide an overall review of the achieved improvements in fiscal efficiency, improved compliance in revenue collection, and improved business environment in terms of reduction of cost and time to operate a business. The minimum agreed number of measurable outputs that will be collected by the implementer of this activity, aggregated and combined by the third party M&E contractor in this process are listed below:

Improved coordination of budget and treasury systems	1. IT system introduced in TS 2. # of new budget users (all levels) and/or governments agencies included in the TS
Government debt management strengthened	Number of procedures/regulations /IT systems introduced
Fiscal Council (FC) strengthened	1.# of procedures and recommendations adopted and implemented by the FC
Public Internal Financial Control strengthened	1. Number of procedures/regulations introduced 2. Number of public institutions that introduced the internal financial control

Tax regime restructured	1. Amount of direct revenue collected increased attributable to USAID assistance
Para-fiscal taxes eliminated	1. Number of para-fiscal taxes eliminated 2. Cost and time savings for businesses

However, the Contractor shall propose an M&E plan that will include all indicators necessary for activity monitoring. The M&E plan shall include baseline data, and clear targets throughout the life of activity. Also, the Contractor shall develop a Performance Indicator Sheet (PIRS) for each indicator in the M&E plan (PIRS template to be provided by USAID/BiH).

The last stage will be the learning process: This is often omitted because organizations have not adopted monitoring and evaluation as a way of evolving, and M&E is often done internally by the missions or projects. Since this is not the case with the Fiscal Reform,( as described above, the third party will be aggregating, analyzing and interpreting the measurable outputs), we can stipulate that the M&E results will be used for learning purposes. The outputs and milestones that will be defined in the work-plan, and measured continuously during the implementation will be used for making adjustments during the project cycle in response to ongoing events.

## Sustainability Analysis

To address the sustainability issue in a broad context, in order to protect the USG investment in the targeted sectors by ensuring permanence of the implemented reforms, EDO decided to design its activities around the relevant recommendations prescribed in the EU accession documents for BiH. These reforms are required for EU accession, so their sustainability is guaranteed by the strict EU conditionality, and driven by the country's strong commitment and keenness to join the EU. USAID also consulted the recommendations for BiH prescribed by the International Monetary Fund and the World Bank.

In order to verify the importance of the activities described in this PAD, USAID had extensive consultations with host government officials during the concept phase of the PAD. The vast majority of the activities proposed in this PAD were recommended by the relevant host government officials, or the local authorities confirmed their interest in the reforms during the consultations. In order to create a sense of ownership with the host government, USAID will include economic governance authorities in all phases of the project implementation. To ensure the buy-in from local authorities, USAID/EDO will insist on partnering with the host government using the G2G model whenever possible. USAID/EDO's technical team plans to identify a pool of strong champions for each of the proposed activities/reforms. These champions may include entire governmental agencies that can carry out the burden of implementation, or individuals from the government that have authority to make changes, NGOs, political parties etc. EDO plans to develop strong cooperation in the form of official

coordinating/implementing bodies/workgroups that will include USG agencies but also the other donors and aforementioned local partners. This broad inclusion of all stakeholders in all phases of planning and implementation was a key ingredient for EDO's achievements and successes in a policy arena to date.

EDO also anticipates that all hardware and software under the project will be procured locally, using the 937 code, to ensure adequate warranties and maintenance of the ICT systems. Furthermore, to ensure appropriate technical skills and transfer of knowledge related to new ICT systems and databases, EDO will explore and insist on maximum engagement of the local ICT consulting companies, and full participation of the beneficiaries/recipients in all phases of the system(s) development.

All activities that are described in this PAD have a strong capacity building component that anticipates extensive training and transfer of knowledge to the final beneficiaries

## Environmental Analysis

As provided in USAID regulation 22 CFR 216 Environmental Procedures, all activities under the Fiscal reform will likely fall under the categorical exclusion provided in Sections 216.2(c)(1)(i) and (c)(2)(i), for training and technical assistance, as they will not result in adverse environmental impacts. An Initial Environmental Examination (IEE) recommending Categorical Exclusion (CE) for all fiscal activities will be submitted to the Bureau Environmental Officer (BEO). The MEO anticipates that the all components of this activity will be categorically excluded from further environmental review.

## Gender Analysis

All activity components will follow the applicable recommendations from 2011 Gender Assessment, and an Assessment update that will follow this year. To ensure gender equality the implementers will be asked to ensure gender balanced representation and participation in policy-making processes. The Project Manager and COR should insist on improving the socio-economic situation of women when analyzing and drafting regulations/policies. Also, Project Manager/COR shall ensure gender balanced participation in all USAID funded capacity building events, trainings, technical assistance programs, study-tours etc.

The SOW author summarized the applicable recommendations bellow:

- Require all implementing partners to collect and report gender-disaggregated data.
- Monitor work plans for consistency with gender considerations in proposals.
- Continue to monitor gender components in evaluation criteria in USAID's procurement processes.
- Improve gender statements in activity approval documents. Ensure that no new activity documents are approved without an adequate gender statement.
- Strengthen gender language in contracts/grants/ cooperative agreements.

## Critical Assumptions and Risks

Based on the current state of country's political environment the following are the critical assumptions and risks that need to be taken into consideration.

Critical assumptions are:

- Continued commitment of BiH authorities to pursue implementation of the project;
- USG assistance budget remains sufficient for effective programming
- Stable political and security situation in the region and in the country;
- Willingness of the local authorities to initiate reforms considering that the reform is initiated in the election year (October 2014)
- EU and other bilateral donors continue supporting BiH on the path to EU membership;

Risks are:

- Lack of political will to implement reforms in the election year;
- Nationalistic rhetoric further divides the reform agenda in BiH;
- Delay in Europe's economic recovery will directly affect BiH's economic outlook through its adverse impact on exports and remittances;
- Attacks to and lack of support for the state-level institutions undermine BiH